THE FIDUCIARY DUTY IN MUTUAL FUND EXCESSIVE FEE CASES: RIPE FOR REEXAMINATION

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ABSTRACT

Congress imposed a fiduciary duty regarding compensation on investment advisors by adding Section 36(b) to the Investment Company Act of 1940. Legislators intended this fiduciary duty to protect mutual fund investors from excessive management fees. It has failed. Mutual fund investors continue to pay significantly higher fees than institutional investors for the same money management services. In Jones v. Harris Associates*, decided in 2008, the Seventh Circuit broke with the widely followed, thirty-year-old precedent of* Gartenberg v. Merrill Lynch Asset Management*. Chief Judge Easterbrook authored the majority opinion and Judge Posner wrote vigorously in dissent. This disagreement between two titans of the law and economics community highlighted the uncertainty surrounding the appropriate fiduciary duty standard for mutual fund excessive fee cases. To address that uncertainty, the Supreme Court will hear* Harris Associates *in November 2009. This Note argues that neither the traditional* Gartenberg *standard nor the market-based* Harris Associates *standard adequately protects investors. To further Congress's goal, the Court should modify, but maintain, the* Gartenberg *standard. This Note's proposed modification—allowing comparisons to institutional investors' fees and eliminating profitability penalties—incorporates market forces into the fiduciary duty standard by introducing a proxy for fairness and encouraging efficiency, but rejects* Harris Associates' *total reliance on the market.*

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INTRODUCTION

> The mutual fund industry is indeed the world's largest skimming operation, a . . . trough from which fund managers, brokers and other insiders are steadily siphoning off an excessive slice of the Nation's household, college and retirement savings.
>
> – Senator Peter Fitzgerald (R-IL)[1]

A penny saved is a penny earned—minus fees. Many Americans[2] save their pennies, and dollars,[3] in mutual funds.[4] Even though the average fund performs worse than the market,[5] investors continue paying billions of dollars in fees to fund managers each year.[6] The level of these fees varies widely,[7] but is not based on the fund's

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1. *Oversight Hearing on Mutual Funds: Hidden Fees, Misgovernance and Other Practices that Harm Investors Before the Subcomm. on Financial Management, the Budget, and International Security of the S. Comm. on Governmental Affairs*, 108th Cong. 3 (2004) (opening statement of Sen. Fitzgerald), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=108_senate_hearings&docid=f:92686.pdf.

2. Almost 90 million American households have assets in mutual funds. INV. CO. INST., 2008 INVESTMENT COMPANY FACT BOOK 8 (48th ed.).

3. In November 2008, the United States' mutual fund industry managed nearly $9.35 trillion. Inv. Co. Inst., *Trends in Mutual Fund Investing: November 2008* (2008), http://www.ici.org/stats/mf/arctrends/trends_11_08.html. At the end of 2007, the mutual fund industry had over $12 trillion under management according to the industry trade group. INV. CO. INST., *supra* note 2, at 20. The value of mutual fund holdings, however, declined sharply, along with the rest of the market, due to the 2008 credit crisis. *See generally* The Joint Economic Committee Majority Staff, *From Wall Street to Main Street: Understanding How the Credit Crisis Affects You* (2008), *available at* http://jec.senate.gov/index.cfm?FuseAction=Files.View&FileStore_id=b2087603-5883-4777-b13e-6b30845d4265 (describing the causes and effects of the credit crisis).

4. Mutual funds are a type of investment company. Investment companies include mutual funds, closed-end funds, and unit investment trusts (UITs). *See* INV. CO. INST., *supra* note 2, at 9 fig.1.1 (aggregating the assets of mutual funds, closed-end funds, exchange-traded funds, and UITs as investment company assets).

5. Burton G. Malkiel, *Are Markets Efficient?—Yes, Even if They Make Errors*, WALL ST. J., Dec. 28, 2000 ("Over the past three-year, five-year and 10-year periods, more than 75% of active [mutual fund] managers underperformed index funds when both are measured after expenses. Those that do outperform in one period are not typically the ones who outperform in the next."); Susan Woodward, *Make Mutual Funds Bare All!*, WALL ST. J., Jan. 16, 2004, at A10.

6. In 2007, investors paid more than $100 billion in mutual fund costs. JOHN C. BOGLE, ENOUGH 44 (2009).

7. *See* PETER J. WALLISON & ROBERT E. LITAN, COMPETITIVE EQUITY: A BETTER WAY TO ORGANIZE MUTUAL FUNDS 9 (2007) ("[T]he expense ratios of the 811 [actively managed U.S. equity] funds range[d] from approximately 60 basis points to 170 basis points, or a difference in cost of almost 300 percent.").

performance.[8] Whether the fund advisor grows investors' money or loses it, the investors pay the advisor a constant percentage of their assets. Perhaps counterintuitively, the more a fund costs, the less it returns to investors.[9] That is, paying a higher price does not buy a better return—but 84 percent of investors believe just the opposite.[10] This misperception transfers wealth from Main Street to Wall Street: from 1995 to 2005, a $1 investment in the average mutual fund in the lowest-cost quartile grew by $2.07, but in the highest-cost quartile, that same $1 investment only grew by $1.18.[11] Fees accounted for that 89 percent growth difference. Those fees went directly from Americans' savings to investment companies' bottom lines.

The industry contends that its fees are set in a competitive and efficient market,[12] but industry critics disagree.[13] Regardless of the efficiency, or inefficiency, of the mutual fund market, Congress has acted to protect shareholders from excessive management fees. In 1970, Congress imposed a fiduciary duty regarding compensation on investment advisors by adding Section 36(b) to the Investment Company Act of 1940 (ICA).[14]

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8. Fees are based on the amount of assets under management. Donald C. Langevoort, *Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 WASH. U. L. Q. 1017, 1020 (2005).

9. JOHN C. BOGLE, THE LITTLE BOOK OF COMMON SENSE INVESTING: THE ONLY WAY TO GUARANTEE YOUR FAIR SHARE OF STOCK MARKET RETURNS 155 (2007) ("Most comparisons of fund costs rely solely on reported expense ratios, and uniformly find that higher costs are associated with lower returns.").

10. Neil Weinberg, *Fund Manager Knows Best*, FORBES, Oct. 14, 2002, at 208.

11. JOHN C. BOGLE, THE BATTLE FOR THE SOUL OF CAPITALISM 162 tbl.7.1 (2005).

12. *See, e.g.*, John C. Coates IV & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. CORP. L. 151, 163 (2007) ("[T]he mutual fund industry's market structure is consistent with competition providing strong constraints on advisory fees."); Inv. Co. Inst., *Key Issues: Fees and Expenses*, http://www.ici.org/issues/fee/index.html (last visited Apr. 14, 2009) ("Investors continue to benefit from intense competition in the financial services industry. In the investment company industry, this vibrant competition has produced substantially lower costs along with an array of innovative investment products and services that make saving and investing simpler, more accessible, and more affordable.").

13. *See, e.g.*, WALLISON & LITAN, *supra* note 7, at 8–13 ("[T]here is strong evidence that the mutual fund industry is not as price competitive as its structure would suggest. . . . [T]he prices . . . are not converging toward a common level, although convergence would be expected in a competitive market."); John P. Freeman, *The Mutual Fund Distribution Expense Mess*, 32 IOWA J. CORP. L. 739, 741 n.8 (2007) ("Through its practice of taking funding directly from fund shareholders, while advocating the interests of shareholders' adversaries when it comes to controversies over fund fees and expenses, the ICI epitomizes the conflicted, self-serving structure of the money management industry it purports to represent.").

14. Investment Company Act § 36(b), 15 U.S.C. § 80a-35(b) (2006) ("For the purposes of this subsection, the investment advisor of a registered investment company shall be deemed to

In practice, this fiduciary duty has failed. Retail mutual fund clients continue to pay investment advisors substantially higher fees than institutional clients.[15] Yet no court has ever found that an investment advisor breached its fiduciary duty to shareholders. The Securities and Exchange Commission (SEC) has never brought suit against an investment advisor for breach of fiduciary duty regarding fees,[16] and shareholders have lost every suit they have brought.[17]

When shareholders sue an investment advisor for charging excessive fees, the shareholders have the burden of proving the breach of a fiduciary duty.[18] To carry this burden, shareholders have traditionally had to meet a multipronged test outlined in the seminal case *Gartenberg v. Merrill Lynch Asset Management*.[19] In May 2008, in *Jones v. Harris Associates*,[20] the Seventh Circuit disapproved the *Gartenberg* standard, creating a circuit split.[21] In an opinion authored by Chief Judge Easterbrook, the court expressed skepticism about *Gartenberg* "because it relies too little on the markets."[22] In a biting dissent from the denial of rehearing,[23] Judge Posner charged that the

have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment advisor or any affiliated person of such investment advisor.").

15. *See infra* note 230. Institutional clients are also referred to as separately managed accounts.

16. *See* Richard M. Phillips, Jeffrey B. Maletta & Mark D. Perlow, *Seventh Circuit Rejects* Gartenberg *but Not Business Judgment*, K&L GATES, June 12, 2008, http://www.klgates.com/newsstand/Detail.aspx?publication=4613 ("The SEC has express statutory authority to bring Section 36(b) cases, although it has not done so.").

17. *See* James D. Cox & John W. Payne, *Mutual Fund Expense Disclosures: A Behavioral Perspective*, 83 WASH. U. L. Q. 907, 914, 923 (2005) ("Plaintiffs are still seeking to achieve their first victory under section 36(b)."); John P. Freeman, Stewart L. Brown & Steve Pomerantz, *Mutual Fund Advisory Fees: New Evidence and a Fair Fiduciary Duty Test*, 61 OKLA. L. REV. 83, 126 (2008) ("[N]o plaintiff has ever won a fee case brought under section 36(b)."); Lyman Johnson, *A Fresh Look at Director "Independence": Mutual Fund Fee Litigation and* Gartenberg *at Twenty-Five*, 61 VAND. L. REV. 497, 519 (2008) ("The most remarkable statistic under section 36(b) is that, thirty-seven years after its enactment and twenty-five years after *Gartenberg*, no investor has obtained a verdict against an investment advisor.").

18. Investment Company Act § 36(b)(1), 15 U.S.C. § 80a-35(b)(1).

19. Gartenberg v. Merrill Lynch Asset Mgmt., 694 F.2d 923 (2d Cir. 1982).

20. Jones v. Harris Assocs., 527 F.3d 627 (7th Cir. 2008).

21. *Id.* at 632 (noting the Fourth Circuit followed *Gartenberg*).

22. *Id.*

23. Judge Posner dissented from the denial of en banc review. *Jones v. Harris Assocs.*, 537 F.3d 728, 729 (7th Cir. 2008) (Posner, J., dissenting from denial of rehearing en banc). He did not sit on the panel that heard *Harris Associates*. In addition to the Chief Judge, the panel was composed of Judges Kanne and Evans. *Harris Assocs.*, 527 F.3d at 627. In his dissent, Judge Posner criticized the panel for its failure to "circulate its opinion to the full court in advance of

panel decision was primarily based on "economic analysis that is ripe for reexamination."[24] This disagreement between two titans of the law and economics community highlighted the uncertainty surrounding the appropriate fiduciary duty standard for mutual fund excessive fee cases. In March 2009, the Supreme Court granted certiorari in *Harris Associates* to address that uncertainty.[25]

This Note examines the controversy surrounding the fiduciary duty standard applied in excessive fee cases and concludes that neither the traditional *Gartenberg* standard nor the market-based *Harris Associates* standard adequately protects shareholders against excessive fees as Congress intended. To further Congress's goals, this Note proposes that the Court should modify, but maintain, the *Gartenberg* standard. This proposed modification incorporates market forces into the fiduciary duty standard by introducing a fairness proxy and by encouraging efficiency, but ultimately rejects *Harris Associates*' total reliance on the market.

The Note proceeds in four Parts. Part I discusses the structure and fees of mutual funds. Part II describes both the traditional *Gartenberg* standard and the market-based *Harris Associates* standard. Part III presents criticisms of the *Gartenberg* standard but maintains that the framework remains useful. It continues with an analysis of the Easterbrook opinion in *Harris Associates.* This analysis demonstrates that, although Chief Judge Easterbrook's opinion tracks his view of corporate law, he ignores the realities of the mutual fund market and engages in unauthorized statutory sunsetting of Section 36(b).[26]

Finally, Part IV proposes a solution to the controversy surrounding the fiduciary duty standard applied in excessive fee cases. *Gartenberg* should stand, with two modifications. First, *Gartenberg*'s comparative fee structure factor must be broadened to include a comparison between the fees charged to captive mutual fund

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publication, as is required when a panel creates a circuit split." *Harris Assocs.*, 537 F.3d at 732 (Posner, J., dissenting from denial of rehearing en banc). This is not the first time Judges Easterbrook and Posner have been on opposite sides of a case exploring the bounds of a fiduciary duty. Judge Easterbrook wrote the majority opinion in *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429 (7th Cir. 1987), with Judge Posner dissenting.

24. *Harris Assocs.*, 537 F.3d at 729 (Posner, J., dissenting from denial of rehearing en banc).

25. Jones v. Harris Assocs., 129 S. Ct. 1579 (2009).

26. *See infra* note 184 and accompanying text.

investors[27] and those charged to independent institutional investors.[28] This change would allow boards and courts to compare the fee paid by the mutual fund shareholders to a fee negotiated at arm's length—a proxy for fairness. Second, *Gartenberg*'s profitability factor should be eliminated. One investment advisor should not be punished for being more profitable than another if that profit comes from efficiency and not increased fees.

I. THE UNIQUE STRUCTURE OF MUTUAL FUNDS AND ITS EFFECT ON FEES

The mutual fund industry's critics point to an inherent conflict of interest regarding fees between investment advisors and shareholders due to the unique structure of mutual funds.[29] This Part describes that unconventional structure, and then explains mutual fund fees and their relation to the structure. It concludes by introducing the fiduciary duty that Congress imposed as a solution to the widely recognized conflict of interest.

A. The Structure of Mutual Funds

Mutual funds are open-end investment companies[30] that pool money from many investors, referred to as shareholders of the fund,

27. Captive investors do not negotiate with the investment advisor at arm's length. *See infra* note 229 and accompanying text. This Note also calls captive mutual fund investors "retail" investors.

28. A pension fund is an institutional investor. *See* Coates & Hubbard, *supra* note 12, at 184 n.131 ("Institutional accounts vary widely, including trusts, foundations, life insurance companies, pension plans, and various levels of high-net-worth individuals.").

29. *See, e.g.*, William A. Birdthistle, *Compensating Power: An Analysis of Rents and Rewards in the Mutual Fund Industry*, 80 TUL. L. REV. 1401, 1409 (2006) ("[T]he industry's faults can be found in the idiosyncratic structure of mutual funds, a structure that exacerbates the ability of managers to wield substantial power and to use that power to extract rents both overtly and surreptitiously from shareholders."); Paul F. Roye, Director, Div. of Inv. Mgmt., SEC, Remarks before the Fund Governance Program Presented by the Mutual Fund Directors Forum and Fund Directions (Dec. 9, 2004) ("I fully understand that conflict oversight and management is not always easy—but it is a core part of your responsibilities as independent fund directors, particularly because of the conflicts inherent in the external management structure of mutual funds."). *Contra* WALLISON & LITAN, *supra* note 7, at 29–31 ("The 'inherent conflict' cited by the SEC and critics of the mutual fund industry, at least as far as fee-setting is concerned, is nothing more than the usual divergence of interests between a buyer and a seller . . . .").

30. *See* 15 U.S.C. § 80a-5(1) (2006) (defining an open-end company as "a management company which is offering for sale or has outstanding any redeemable security of which it is the issuer").

and then invest in a diversified portfolio of stocks, bonds, and other securities.[31] Mutual funds are valuable because they allow small investors to diversify their holdings and thus reduce risk.[32] They also provide professional management, liquidity,[33] variety,[34] and convenience to investors.

Although mutual funds have the trappings of typical corporations, their external management structure sets them apart.[35] Like other corporations, for example IBM or General Motors, mutual funds are independent legal entities, owned by shareholders with voting rights and governed by a board of directors.[36] But commentators have described mutual funds as "captive shell[s],"[37] "Spartan business organizations,"[38] and "rudimentary legal vessel[s]"[39] because, unlike typical corporations, mutual funds are externally managed. That is, third parties perform all of the functions that the fund must perform to increase value. The fund itself has "no offices, no equipment, and no employees."[40] The third parties that a mutual fund relies on include an investment advisor, an underwriter

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31. SEC, *Mutual Funds*, http://www.sec.gov/answers/mutfund.htm (last visited Apr. 14, 2009).

32. WALLISON & LITAN, *supra* note 7, at 2 ("One of the most basic rules of personal finance is never to put all of one's financial eggs in one basket. . . . This advice follows from the efficient market hypothesis, which holds that no single investor can have more information at any given moment than is in the market as a whole, and therefore no investor, no matter how skilled, can consistently 'beat the market' in picking individual securities.").

33. Redeemable shares are a hallmark of mutual funds. Redeemable shares entitle investors to sell their shares back to the fund at the current net asset value minus any redemption or deferred sales load fees. *See* SEC, *supra* note 31 (describing traditional and distinguishing characteristics of mutual funds, including redeemable shares). Because shares are redeemable, new sales are crucial to the fund's existence. Without new sales, a fund could be redeemed out of existence. John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. CORP. L. 609, 614 (2001).

34. In 2007, there were 8,752 mutual funds (including funds of funds). INV. CO. INST., *supra* note 2, at 15 fig.1.8.

35. *See* INV. CO. INST., A GUIDE TO UNDERSTANDING MUTUAL FUNDS 10 (2008), *available at* http://www.ici.org/pdf/bro_understanding_mfs_p.pdf ("Virtually all mutual funds are externally managed; they do not have employees of their own. Instead, their operations are conducted by affiliated organizations and independent contractors.").

36. A. Joseph Warburton, *Should Mutual Funds Be Corporations? A Legal & Econometric Analysis*, 33 J. CORP. L. 745, 748 (2008).

37. John A. Otoshi, Note, *Class Action Treatment of Shareholders' Suits Under Section 36(b) of the Investment Company Act*, 83 COLUM. L. REV. 2039, 2039 (1983).

38. Birdthistle, s*upra* note 29, at 1418.

39. *Id.* at 1409.

40. *Id.*

(typically a securities dealer), and a transfer agent (typically a bank).[41] This Note focuses on the investment advisor.

The investment advisor is a professional money manager, independent of, but tightly connected to, the mutual fund.[42] The investment advisor handles day-to-day management of the fund, which includes research regarding which securities to buy and sell and portfolio management.[43] Additionally, the advisor completes the more pedestrian tasks of procuring office space and overseeing administrative staff.[44] The investment advisor is often the fund's initial sponsor and initial shareholder.[45] Most funds are named for and marketed by their investment advisors.[46] The close nexus between the investment advisor and the fund remains over time because after the advisor "gives birth to the fund. . . . the umbilical cord is never cut."[47]

The investment advisor becomes even more tightly connected to the fund through the board of directors. The board of a mutual fund, like any corporate board, is charged with serving the interests of the shareholders.[48] The board's additional responsibilities include selecting the investment advisor and other third-party providers, reviewing yearly third-party contracts,[49] approving the investment advisor's fees, establishing the fund's investment objectives, and policing conflicts.[50] The sponsor, again typically the investment advisor, appoints officers and affiliated directors to serve on the board. Then the investment advisor "*recruits unaffiliated* persons to

41. For more information on the role of the underwriter and transfer agent, see William P. Rogers & James N. Benedict, *Money Market Fund Management Fees: How Much Is Too Much?*, 57 N.Y.U. L. REV. 1059, 1063 nn.10–11 (1982). For a brief overview of the types of service providers a fund typically relies on, see INV. CO. INST., *supra* note 2, at 164–68.

42. The investment advisor is a legal entity that has its own employees. INV. CO. INST., *supra* note 2, at 166. Merrill Lynch, Harris Associates, and Fidelity are examples of investment advisors.

43. *Id.* at 166–67.

44. Rogers & Benedict, *supra* note 41, at 1063.

45. INV. CO. INST., *supra* note 2, at 166.

46. *See* Edward Wyatt, *Empty Suits in the Board Room; Under Fire, Mutual Fund Directors Seem Increasingly Hamstrung*, N.Y. TIMES, June 7, 1998, at C1 ("In practice, of course, the entire operation is run by one fund company—Fidelity or Merrill Lynch, Navellier or Fundamental—which not only provides . . . services, but is the brand name that brings shareholders to the fund.").

47. Conference on Mutual Funds, 115 U. PA. L. REV. 726, 739 (1967) (remarks of Abraham L. Pomerantz).

48. Rogers & Benedict, *supra* note 41, at 1064.

49. 15 U.S.C. § 80a-15(c) (2006).

50. Warburton, *supra* note 36, at 750.

serve as independent directors."[51] Permitting investment advisors to select all of the members of the board reduces the likelihood that directors will strike hard bargains with investment advisors.[52] Additionally, individuals often serve on more than one board in a mutual fund complex managed by the investment advisor, and can reap substantial aggregate pay from these directorships. For example, in the Fidelity complex of funds, nine individuals served as independent directors for all 237 investment companies in the complex.[53] Fidelity paid those individuals annual salaries ranging from $220,500 to $273,500.[54]

Many critics have challenged the independence and effectiveness of mutual fund boards in light of this close nexus with the investment advisors. Professor Abraham L. Pomerantz, an early critic, notes the conflict: "[O]f all dualities and of all conflicts [in the American corporate] scene, nothing—but nothing—approaches the open end mutual fund for incestuous relationships."[55] He also criticizes how unaffiliated directors are chosen, noting that "[t]he men who need to be watched pick the watchdogs to watch them."[56] Professor Lyman Johnson also recognizes the conflict that arises when employees of the investment advisor sit on the board of the mutual fund—the employees and board members personally benefit from a contract that is good for the advisor, but adverse to the interests of the investor.[57] Johnson calls for a more robust conception of director independence in mutual funds to protect shareholders, akin to that in other corporations.[58] Industry insider and critic John C. Bogle[59] explains that investment advisors seek high returns not only for investors, but also for themselves. Noting that some investment advisors are publicly held, Bogle observes that they are beholden to the shareholders of their stock, not merely the shareholders of the

51. INV. CO. INST., *supra* note 2, at 165 (emphasis added).

52. Rogers & Benedict, *supra* note 41, at 1072.

53. Krantz v. Fidelity Mgmt. & Research Co., 98 F. Supp. 2d 150, 151 (D. Mass. 2000).

54. *Id.* at 151–52; *see also* Migdal v. Rowe Price-Fleming Int'l, Inc., 248 F.3d 321, 330–31 (4th Cir. 2001) (dismissing a claim that overlapping service between twenty-two and thirty-eight boards with an aggregate compensation of either $65,000 or $81,000 rendered directors "interested").

55. Conference on Mutual Funds, *supra* note 47, at 739 (remarks of Abraham L. Pomerantz).

56. *Id.* Pomerantz called for more SEC regulation. *Id.* at 740.

57. Johnson, *supra* note 17, at 505.

58. *Id.* at 527–34.

59. Founder and former CEO of The Vanguard Group.

fund.[60] Perhaps surprisingly, two of the top three best performing American stocks from 1982 through 2007 were mutual fund sponsors—not funds themselves. Franklin Resources, in first place, had an overall return of 64,224 percent, whereas Eaton Vance, a Boston-based fund manager, returned 38,444 percent. By comparison, Berkshire Hathaway, Warren Buffet's conglomerate, returned a paltry 19,424 percent.[61]

The widely recognized,[62] close nexus between the investment advisor and the fund has undermined the idea that boards impose meaningful limits on investment advisors—especially because boards are loathe to fire them.[63] One observer notes that "the termination of advisory agreements is so rare as to be practically nonexistent."[64] Firing an investment advisor would fundamentally alter the fund. Investors do not choose to invest in a fund because of the composition of the board; instead they invest with a particular investment advisor. After all, it is the advisor's name on the fund and not the board's. If the board fires the advisor it may nullify an essential reason many investors chose that fund.[65] Boards may conclude that if investors are unhappy they will redeem their shares and invest elsewhere. Although the fund board of directors theoretically has the right to demand lower fees and fire investment advisors, boards rarely exercise those rights.[66] That drastically reduces

60. BOGLE, *supra* note 6, at 145–46.

61. '*If Only I Had Bought . . .*', USA TODAY, Apr. 16, 2007, at 8B, *available at* http://www.usatoday.com/money/top25-stocks.htm.

62. *See, e.g.*, Gartenberg v. Merrill Lynch Asset Mgmt., 694 F.2d 923, 929–30 (2d Cir. 1982) ("Congress . . . recognized . . . the potentially incestuous relationships between many advisers and their funds . . . ."); U.S. GEN. ACCOUNTING OFFICE, MUTUAL FUND FEES: ADDITIONAL DISCLOSURE COULD ENCOURAGE PRICE COMPETITION 82 (2000) ("Although most mutual funds are organized as corporations, their structure and operation differ from a typical corporation because of the relationship between the fund and its adviser. Typically, the adviser, who is a legal entity separate from the fund, conducts the fund's operations, and the advisory fees it charges to the fund represent revenue to the adviser, creating a possible conflict of interest.").

63. Even industry supporters acknowledge that boards "rarely fire" investment advisors. Coates & Hubbard, *supra* note 12, at 153. The authors, however, do not reach the conclusion that the structure of mutual funds prevents competition. *Id.* at 153–54.

64. Birdthistle, *supra* note 29, at 1410. Chief Judge Easterbrook recognized this reality in *Harris Associates*. Jones v. Harris Assocs., 527 F.3d 627, 634 (7th Cir. 2008) ("Mutual funds rarely fire their investment advisers . . . .").

65. For example, thousands of investors flocked to the Magellan Fund to have Peter Lynch manage their money. *See* PETER S. LYNCH & JOHN ROTHCHILD, BEATING THE STREET 82–139 (1993) (describing the Magellan Fund).

66. Freeman & Brown, *supra* note 33, at 617.

the board's ability to control the investment advisor for the benefit of the shareholders.

B. Mutual Fund Fees: An Overview

The investment advisor is compensated through fees set in the board-approved management contract.[67] These fees are based on assets under management. The advisor is paid the same percentage for good performance or bad performance. Since markets tend to rise over time, the assets' value rises over time, which leads to steady fee increases over time, even without the manager adding value.[68] Because the fee level is not linked to performance, an investment advisor can generate a greater fee by either growing the fund's assets through successful investing or by attracting new investors through promotion. Investors benefit from the former, but gain relatively little from the latter.[69] Indeed, attracting new investors harms current investors because the current investors, rather than the advisor, pay the costs of recruiting new investors through 12b-1 fees.[70] Thus, the advisor has an incentive to increase the number of investors, which increases its bottom line at the expense of fund shareholders.

Investors pay two kinds of fees to their investment advisors: one-time fees and ongoing expenses.[71] One-time fees, sometimes called loads or sales charges, are transaction costs. They are a commission paid to a broker when an investor buys (sales load) or sells (back-end load or sales charge) shares. One-time fees are readily observable and more transparent than ongoing fees.[72]

Ongoing fees are more pernicious for shareholders. Funds can hide them from investors because funds deduct them from fund assets before the funds distribute earnings to shareholders.[73] These ongoing fees include a management fee, distribution fees (known as 12b-1

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67. *See* 15 U.S.C. § 80(a)–15(c) (2006) (mandating board control over advisory contracts).

68. *Money for Old Hope*, ECONOMIST, Mar. 1, 2008, at 3 (discussing the asset management business as a whole, which includes but is not limited to mutual funds, and noting that "fees in the industry tend to grow at around 15% a year because markets rise by an average of 8% and savings grow by 5-6%.").

69. Langevoort, *supra* note 8, at 1021.

70. *See infra* notes 74–77.

71. INV. CO. INST., FREQUENTLY ASKED QUESTIONS ABOUT MUTUAL FUND FEES 2–5 (2004), *available at* http://www.ici.org/pdf/bro_mf_fees_faq_p.pdf.

72. Cox & Payne, *supra* note 17, at 925.

73. INV. CO. INST., *supra* note 71, at 6.

fees),[74] and other expenses.[75] The largest of these ongoing expenses is the management fee, which is the fee the investment advisor charges for managing the fund's portfolio of securities and providing related services.[76] 12b-1 fees pay for marketing and advertising activities and compensate salespeople who steer investors to the fund.[77] The final category of ongoing fees, "other expenses," is a catchall category that includes administrative costs like mailing and printing charges, as well as shareholder services such as toll-free phone lines and computerized account services.[78]

C. Investment Advisors Have a Fiduciary Duty regarding Fees

Congress has recognized the risk of self-dealing in the mutual fund industry relating to fees.[79] Under the ICA, enacted in 1940, the board of directors, particularly the unaffiliated directors, was charged with defending investors against self-dealing by investment advisors.[80] Because of the mutual fund industry's rapid growth in the 1950s, the SEC authorized the Wharton School of Finance and Commerce at the University of Pennsylvania to study the industry.[81] The Wharton Report found that investment advisors charged "relatively high rates,"[82] which competitive market forces did not reduce because of the close association between the advisors and the fund.[83] Further, the report noted that the advisory fees charged to mutual fund clients were "substantially higher" than those charged to institutional investors.[84] In the 1960s, the SEC conducted its own study of the mutual fund industry, which concluded that the existing restraints on

74. The authority for the distribution fee comes from the ICA Rule 12b-1, 17 C.F.R. § 270.12b-1 (2009). For a criticism of 12b-1 fees, see generally Freeman, *supra* note 13.

75. INV. CO. INST., *supra* note 71, at 4–5.

76. *Id.* at 4.

77. *Id.* at 4–5. For other readings regarding 12b-1 fees, see Cox & Payne, *supra* note 17, at 925 n.87.

78. INV. CO. INST., *supra* note 71, at 9.

79. *See* Freeman & Brown, *supra* note 33, at 616 ("To protect fund shareholders from self-dealing, Congress imposed a requirement that at least forty percent of a fund board needs to be composed of directors ostensibly independent of the investment advisor.").

80. Rogers & Benedict, *supra* note 41, at 1070.

81. Wharton School of Finance and Commerce, A Study of Mutual Funds, H.R. Rep. No. 87-2274, at 28 (1966).

82. *Id.* at 29.

83. *See id.* at 30 ("[T]he special structural characteristics of this industry, with an external adviser closely affiliated with the management of the mutual fund, tend to weaken the bargaining position of the fund in the establishment of advisory fee rates.").

84. *Id.* at 29.

investment advisors did not adequately protect investors.[85] The SEC recommended substantial modifications to the ICA to address the problems with management fees.[86]

In response to the SEC Report and the Wharton Report, Congress added Section 36(b) to the ICA in 1970.[87] Section 36(b) established a fiduciary duty with respect to compensation between the investment advisor and the shareholders.[88] This fiduciary duty replaced the corporate waste standard that previously had been the threshold to prove excessive fee cases.[89] Section 36(b) notes that courts should give director and shareholder approval of management fees "such consideration . . . as is deemed appropriate under all the circumstances."[90] Both shareholders and the SEC have an express right to sue under the statute.[91] The plaintiff has the burden of proving a breach of fiduciary duty, but is not required to show that "any defendant engaged in personal misconduct."[92]

II. THE UNCERTAIN STATE OF THE FIDUCIARY DUTY STANDARD UNDER SECTION 36(B)

The enactment of Section 36(b) reflects a policy choice to imbue what was merely a contractual relationship with a fiduciary duty.[93]

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85. *See* Report of the SEC on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 89-2337, at 12–13 (1966) (discussing the various ways in which the existing restraints on management compensation are inadequate, and providing recommendations to rectify the problem of unreasonable compensation).

86. *Id.* at 13; Rogers & Benedict, *supra* note 41, at 1081 (discussing the modifications the SEC recommended).

87. WALLISON & LITAN, *supra* note 7, at 32.

88. In pertinent part Section 36(b) provides:

> For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser.

15 U.S.C. § 80a-35(b) (2006).

89. *See* Rogers & Benedict, *supra* note 41, at 1088 ("Prior to enactment of the section, courts had held that once a defendant demonstrated that a management fee was approved by the board and the shareholders of the fund, the plaintiff was required to establish that the fee was so high as to constitute a waste of corporate assets. This corporate waste standard had proved virtually impossible for plaintiffs to meet, and, in effect, precluded legal challenges to management fees." (footnotes omitted)).

90. 15 U.S.C. § 80a-35(b)(2).

91. *Id.* § 80a-35(b).

92. *Id.* § 80a-35(b)(1).

93. Johnson, *supra* note 17, at 528.

Congress did not leave fees to be determined by the market alone.[94] Unfortunately, Congress did not define or explain the term "fiduciary duty" as used in Section 36(b).[95] Nor did the SEC and the mutual fund industry, the two primary actors engaged in the legislative debates, ever agree on what a fiduciary duty required.[96] That task has been left to the courts.

A. *The Traditional Approach:* Gartenberg v. Merrill Lynch Asset Management

Gartenberg is the seminal case interpreting the fiduciary duty requirement of Section 36(b). The plaintiffs held shares in the then-largest money market mutual fund.[97] They claimed that the fund realized cost savings through economies of scale[98] but was not passing the savings on to shareholders through lower fees.[99] The plaintiffs urged that a "reasonableness" standard was the proper way to determine whether a breach of fiduciary duty occurred.[100] The plaintiffs further contended that the district court erred by relying primarily on the management fees of other money market funds when determining if the defendants breached a fiduciary duty.[101] The plaintiffs argued for an arm's-length negotiation standard, which could not be satisfied by comparing fees between funds that were captives of their advisor, as is the case in all mutual funds.[102]

The plaintiffs in *Gartenberg* lost; they failed to prove economies of scale existed or, even if they did exist, that they were not shared with shareholders.[103] The court set forth two important frameworks

94. *See* Langevoort, *supra* note 8, at 1037 ("Once the mutual fund is viewed as a product to be marketed within liberal societal expectations as to fair advertising like any other, then any notion that the producer is a 'fiduciary' is awkward and disorienting. The transaction is instead simply embedded in the morals of the marketplace. To be sure, the law disagrees—the adviser *is* deemed a fiduciary to the fund and its investors." (footnotes omitted)).

95. *See* Green v. Nuveen Advisory Corp., 295 F.3d 738, 742 (7th Cir. 2002) ("[Section] 36(b) does not explain the term 'fiduciary duty' . . . .").

96. Rogers & Benedict, *supra* note 41, at 1082–89 ("[T]he Commission and the industry never did concur on what the term 'fiduciary duty' meant in this context.").

97. Gartenberg v. Merrill Lynch Asset Mgmt., 694 F.2d 923, 925, 928 (2d Cir. 1982).

98. Economies of scale are the cost advantages a firm realizes as it grows. *See* CAMPBELL R. MCCONNELL & STANLEY L. BRUE, MICROECONOMICS 160–62 (16th ed. 2004) (discussing economies of scale).

99. *Gartenberg*, 694 F.2d at 928.

100. *Id.* at 927.

101. *Id.* at 927–28.

102. *Id.* at 928.

103. Freeman & Brown, *supra* note 33, at 645.

that have guided excessive fee decisions and boards approving fees since 1982. First, "[t]o be guilty of a violation of § 36(b), therefore, the adviser-manager must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining."[104] Next, the court outlined six factors to consider when applying Section 36(b)'s fiduciary duty standard: "(a) the nature and quality of services provided to fund shareholders; (b) the profitability of the fund to the adviser-manager; (c) fallout benefits; (d) economies of scale; (e) comparative fee structures; and (f) the independence and conscientiousness of the trustees."[105]

Courts and boards of directors use the *Gartenberg* framework. Courts of appeals in the Third[106] and Fourth Circuits[107] have followed it, along with many district courts.[108] Mutual fund boards must consider each *Gartenberg* factor in their fee approval process[109] because the SEC adopted rules that require boards to disclose their analysis of each factor.[110] Although no shareholder has ever prevailed against an investment advisor in court under *Gartenberg*, shareholders have achieved some settlements.[111]

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104. *Gartenberg*, 694 F.2d at 928.

105. Krinsk v. Fund Asset Mgmt., 875 F.2d 404, 409 (2d Cir. 1989) (citing *Gartenberg*, 694 F.2d at 929–30).

106. Krantz v. Prudential Invs. Fund Mgmt. LLC, 305 F.3d 140, 143 (3d Cir. 2002) (per curiam).

107. Migdal v. Rowe Price-Fleming Int'l, Inc., 248 F.3d 321, 326–27 (4th Cir. 2001).

108. *See, e.g.*, Lori A. Martin & Martin Lybecker, *It's Too Early to Disregard the* Gartenberg *Factors During Advisory Fee Renewals*, WILMERHALE, May 27, 2008, http://www.wilmerhale.com/publications/whPubsDetail.aspx?publication=8329 (noting that *Gartenberg* "has been applied by district courts in the First, Second, Third, Fourth, Fifth, Eighth, Ninth and Tenth Circuits").

109. *See* Phillips et al., *supra* note 16 ("[D]irectors should continue to engage in a thoroughgoing Section 15(c) process that considers the *Gartenberg* factors, along with other information the directors deem important, in determining the reasonableness of management fees.").

110. Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, 69 Fed. Reg. 39,797, 39,801 (June 30, 2004) (codified at 17 C.F.R. pts. 239, 240, and 274).

111. JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, SECURITIES REGULATION, CASES AND MATERIALS 1116–17 (5th ed. 2006).

B. The Market Approach: Jones v. Harris Associates

1. *A New Sherriff in Town—Easterbrook's Disclosure-Based Approach*. In *Jones v. Harris Associates*, decided in May 2008, Chief Judge Frank Easterbrook authored an opinion disapproving the *Gartenberg* approach.[112] *Harris Associates* stands alone as the only appellate opinion rejecting *Gartenberg*.

The plaintiff shareholders sued Harris Associates, the investment advisor to the Oakmark complex of mutual funds,[113] contending that the advisor's fees were excessive.[114] Though the plaintiffs applied the *Gartenberg* factors to their set of facts, they "urge[d] the court to consider whether *Gartenberg* should be uncritically accepted and applied."[115] The plaintiffs highlighted two "serious flaws"[116] with the *Gartenberg* standard: first, *Gartenberg* fails to appreciate the immateriality of recent fund performance;[117] second, it understates the fiduciary duty standard, which they contended should be a reasonableness standard.[118]

Not only did the *Harris Associates* plaintiffs question the *Gartenberg* factors generally, like the *Gartenberg* plaintiffs,[119] they disagreed specifically with the district court's application of the comparative fee structure factor.[120] They argued the application was flawed because it did not consider that the fees are set incestuously.[121] The district court did not allow the comparison to institutional investors, which the plaintiffs argued was the best example of a fee negotiated at arm's length.[122]

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112. Jones v. Harris Assocs., 527 F.3d 627, 632 (7th Cir. 2008) ("Having had another chance to study this question, we now disapprove the *Gartenberg* approach.").

113. *Id.* at 629.

114. *Id.* at 631.

115. Brief and Required Short Appendix of Plaintiffs-Appellants at 33, Jones v. Harris Assocs., No. 07-1624 (7th Cir. 2008), 2007 WL 1582568 [hereinafter Brief of Plaintiffs].

116. *Id.* at 34.

117. *Id.*

118. *Id.* at 34–35.

119. *See supra* note 101 and accompanying text.

120. Brief of Plaintiffs, *supra* note 115, at 37.

121. *Id.*; Jones v. Harris Assocs., 527 F.3d 627, 631 (7th Cir. 2008).

122. Brief of Plaintiffs, *supra* note 115, at 27. Chief Judge Easterbrook conflated the plaintiffs' arguments regarding the district court's comparative fee analysis with the plaintiffs' description of *Gartenberg*'s flaws. *Compare Harris Assocs.*, 527 F.3d at 631 (stating that the plaintiffs contended that the court should not follow *Gartenberg* because it relies too much on the market and disregards the fees charged to institutional clients), *with* Brief of Plaintiffs, *supra*

As the plaintiffs requested, the Seventh Circuit did not uncritically accept *Gartenberg*. But unlike the plaintiffs, the court thought that *Gartenberg* relied "too little on markets."[123] The court rejected both the plaintiffs' reasonableness test[124] and the *Gartenberg* standard.[125] Under its own, new framework, the Seventh Circuit concluded that "[a] fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation."[126] The court qualified this standard in the case of unusual fees: "It is possible to imagine compensation so unusual that a court will infer that deceit must have occurred, or that the persons responsible for [the] decision have abdicated . . . ."[127]

Chief Judge Easterbrook's new approach relies heavily on the markets and works from a baseline assumption that the mutual fund market is efficient.[128] It rejects any instruction gleaned from the debates of the late 1960s and 1970 regarding the poor state of mutual fund competition.[129] Instead, Chief Judge Easterbrook wryly observed that "[a] lot has happened in the last 38 years."[130] The Seventh Circuit's approach relies on self-regulating markets and the findings of an academic article authored by John C. Coates and R. Glenn Hubbard.[131] Easterbrook highlighted that the Coates and Hubbard study determined that "thousands of mutual funds are plenty, that investors can and do protect their interests by shopping, and that regulating advisory fees through litigation is unlikely to do more good

note 115, at 33–37 (noting that the comparative fee structure analysis of the district court was inappropriate because it assumed market competition set mutual fund fee rates and ignored a comparison to institutional clients' fees, but urging the court to consider whether *Gartenberg* should be uncritically accepted because it fails to appreciate the immateriality of recent fund performance and understates the fiduciary duty standard).

123. *Harris Assocs.*, 527 F.3d at 632.

124. *Id.* ("Section 36(b) does not say that fees must be 'reasonable' in relation to a judicially created standard. It says instead that the adviser has a fiduciary duty.").

125. *See supra* note 112 and accompanying text.

126. *Harris Assocs.*, 527 F.3d at 632.

127. *Id.* At first blush this standard seems similar to *Gartenberg*'s "disproportionately large" standard, but, as Judge Posner's dissent points out, the panel's standard can only be compared to other mutual fund fees, whereas the *Gartenberg* standard is "not so limited." Jones v. Harris Assocs., 537 F.3d 728, 732 (7th Cir. 2008) (Posner, J., dissenting from denial of rehearing en banc).

128. *Harris Assocs.*, 527 F.3d at 634 ("Mutual funds come much closer to the model of atomistic competition than do most other markets.").

129. *See supra* notes 81–85 and accompanying text (describing the mutual fund studies of the 1960s).

130. *Harris Assocs.*, 527 F.3d at 633.

131. *Id.* at 634 (citing Coates & Hubbard, *supra* note 12).

than harm."[132] The Chief Judge was particularly concerned that Section 36(b)'s fiduciary duty not be interpreted as a means of judicial price setting or rate regulation.[133] Instead, he declared that securities laws "work largely by requiring disclosure and then allowing price to be set by competition in which investors make their own choices."[134] He disregarded comparisons between institutional investors and captive mutual funds because "no court would inquire whether a salary normal among similar institutions is excessive."[135] The plaintiffs lost because Harris Associates did not "pull[] the wool over the eyes of the disinterested trustees."[136] The panel rejected the notion that the captivity of mutual funds curtails competition.[137] The Seventh Circuit denied the plaintiffs' petition for en banc review.[138]

2. *Posner Dissents*.[139] "Everyone loves a brawl. And all the more so when the brawlers are smart, biting, literate debaters . . . ."[140] Chief Judge Easterbrook and Judge Posner are "*the* heavyweights"[141] of the law and economics movement. Posner's dissent hit back against Easterbrook's panel opinion and highlighted the aberrational nature of the panel opinion. Judge Posner questioned the economics underlying the panel decision, framed mutual fund fees as executive

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132. *Id.*

133. *Id.* at 635 ("As § 36(b) does not make the federal judiciary a rate regulator, after the fashion of the Federal Energy Regulatory Commission, the judgment of the district court is affirmed."); *id.* at 633 ("Section 36(b) does not create a rate-regulation mechanism, and plaintiffs' proposal to create such a mechanism in 2008 cannot be justified by suppositions about the market conditions of 1970."); *id.* ("Judicial price-setting does not accompany fiduciary duties. Section 36(b) does not call for a departure from this norm.").

134. *Id.* at 635.

135. *Id.* at 632.

136. *Id.* at 635.

137. *Id.* at 632.

138. Jones v. Harris Assocs., 537 F.3d 728, 729 (7th Cir. 2008) (per curiam).

139. The panel voted unanimously to deny the plaintiffs' petition for a rehearing. But the rules of the Seventh Circuit permit a judge to request that any motion be considered by the court en banc. 7th Cir. R. 1(a)(2). A judge, likely Judge Posner, requested a vote on the request for an en banc hearing. Since a majority of the circuit did not favor a rehearing, the petition was denied. Judge Posner dissented from that denial. Jones v. Harris Assocs., 537 F.3d 728, 729 (7th Cir. 2008) (Posner, J., dissenting from denial of rehearing en banc).

140. J. Mark Ramseyer, Commentary, *Not-So-Ordinary Judges in Ordinary Courts: Teaching* Jordan v. Duff & Phelps, Inc., 120 HARV. L. REV. 1199, 1199 (2007) (detailing another case in which Judges Easterbrook and Posner disagreed on a fiduciary duty standard).

141. Floyd Norris, *The Supremes Will Decide Which Economics Makes Legal Sense*, N.Y. TIMES, Mar. 9, 2009, http://norris.blogs.nytimes.com/2009/03/09/the-supremes-will-decide-which-economics-makes-legal-sense/.

compensation,[142] rejected the argument that boards protect investors, and advocated examining the fee differences between institutional investors and retail investors.

Though Easterbrook said that *Harris Associates* was not the first time the Seventh Circuit had questioned *Gartenberg*,[143] Posner pointed out that both cases Easterbrook cited to suggest a previous disagreement with *Gartenberg* were not excessive fee cases.[144] Judge Posner called the economic analysis underlying the panel opinion "ripe for reexamination,"[145] and quipped that the panel "misse[d] the point"[146] regarding unreasonable compensation as evidence of a breach of fiduciary duty.[147] Questioning Easterbrook's rejection of *Gartenberg*, Posner observed that the academic article Easterbrook relied on "expressly approves *Gartenberg*,"[148] and that the standard has not proven very hard on advisors.[149]

Posner approached mutual fund boards of directors with skepticism. He rejected Easterbrook's faith in boards, noting the "feeble incentives of boards of directors to police compensation."[150] In addition, he remarked that boards are often composed of CEOs of other companies and thus boards are likely to highly value, and compensate, the role.[151] Judge Posner highlighted the shortcomings of the incentive structure and its detrimental effect on competition by citing Northwestern business school Professor Camelia M. Kuhnen, who has said, "[f]und directors and advisory firms that manage the funds hire each other preferentially based on past interactions. When directors and the management are more connected, advisors capture more rents and are monitored by the board less intensely."[152]

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142. For a critical commentary on executive compensation by Judge Posner, see generally Richard A. Posner, *Are American CEOs Overpaid, and, if So, What if Anything Should Be Done About It?*, 58 DUKE L.J. 1013 (2009).

143. *Harris Assocs.*, 527 F.3d at 632. Chief Judge Easterbrook cited *Green v. Nuveen Advisory Corp.*, 295 F.3d 738 (7th Cir. 2002), and *Green v. Fund Asset Management*, 286 F.3d 682 (3d Cir. 2002).

144. *Harris Assocs.*, 537 F.3d at 729 (Posner, J., dissenting from denial of rehearing en banc).

145. *Id.* at 730.

146. *Id.* at 732.

147. *Id.*

148. *Id.* at 729.

149. *Id.* at 730.

150. *Id.*

151. *Id.*

152. *Id.* at 730–31 (quoting Camelia M. Kuhnen, *Social Networks, Corporate Governance and Contracting in the Mutual Fund Industry* (Mar. 1, 2007), http://ssrn.com/abstract=849705).

Finally, Posner was concerned about the price differential between the plaintiff mutual fund investors and independent funds.[153] The mutual fund investors, whom Posner referred to as "captives," pay more than twice what the independent funds pay.[154] Easterbrook accepted the difference because "[d]ifferent clients call for different commitments of time."[155] Easterbrook suggested several reasons why mutual funds may take more time, and thus cost more, than pension funds.[156] Posner called Easterbrook's suggestions "purely . . . speculation, rather than anything having an evidentiary or empirical basis."[157] He then explained that the panel's "so unusual" standard only applies to comparisons among mutual funds, preventing comparisons of mutual funds to the institutional investors who negotiate at arm's length—a comparison that *Gartenberg*'s "so disproportionately large" standard may permit.[158] Because the governance structure of mutual funds that has produced the current fee levels is industry-wide, Posner cautioned that rejecting comparisons among institutional and retail investors could lead to a price floor.[159]

Though Posner conceded that the "*outcome* of this case may be correct,"[160] he strongly rejected the process. He concluded that the Seventh Circuit should have heard the case en banc for three reasons: its decision created a circuit split, the issue was extremely important to the mutual fund industry, and the panel's analysis was "one-sided."[161] This public, foundational disagreement between the two "leading lights"[162] of the law and economics community made *Harris Associates* a news item[163] and left in its wake significant uncertainty about the state of the fiduciary duty standard in excessive fee cases.[164]

153. *Id.* at 731.

154. *Id.*

155. Jones v. Harris Assocs., 527 F.3d 627, 634 (7th Cir. 2008).

156. *Id.*

157. *Harris Assocs.*, 537 F.3d at 731 (Posner, J., dissenting from denial of rehearing en banc).

158. *Id.* at 732.

159. *Id.* A price floor is the value below which a price will not, or will not be allowed to, fall.

160. *Id.*

161. *Id.* at 732–33.

162. Norris, *supra* note 141.

163. *E.g.*, Floyd Norris, *Judges in Dispute over Mutual Funds*, N.Y. TIMES, Aug. 15, 2008, at C3, *available at* http://www.nytimes.com/2008/08/16/business/16place.html.

164. *See, e.g.*, Ropes & Gray, *Appeals Court Rejects Mutual Fund Excessive Fee Claims, Adopting New Standard for Evaluation of Fees*, ROPES & GRAY, May 20, 2008,

Speculation began about whether the Supreme Court would step in and reconcile the disagreement,[165] with one commentator going so far as to suggest that Posner's dissent resembled an "appellate brief, and could help to get this issue before the Supreme Court."[166] In March 2009, likely based on at least two of the reasons that Posner cited to call for en banc review—namely, the circuit split and the importance of the issues—the Supreme Court granted certiorari.[167]

III. ANALYSIS OF *GARTENBERG* AND *HARRIS ASSOCIATES*

On November 2, 2009, the Supreme Court will hear arguments regarding the appropriate fiduciary duty standard to be applied in excessive fee cases.[168] Scholars have spilled a significant amount of ink discussing the shortcomings of the traditional *Gartenberg* approach to the fiduciary duty standard. Section A of this Part surveys those criticisms of *Gartenberg*. Section B critiques *Harris Associates*. This Note then continues to Part IV, which proposes a fiduciary duty standard that harnesses the power of the market by modifying *Gartenberg*.

A. Criticism of the Gartenberg *Standard*

Though *Gartenberg* has been widely used by the judiciary and the SEC, some academics have strongly criticized it. One of the industry's most prolific critics, Professor John P. Freeman, calls the *Gartenberg* factors "passé,"[169] noting that "[t]hey were of limited use originally, but today they are of no use at all."[170] He characterizes *Gartenberg* as "creat[ing] an unworkable, unfair, scavenger hunt-style liability test"[171] and goes on to call the current system for determining breaches of fiduciary duty a "failure."[172] In 2001, Freeman and Brown concluded that mutual funds were being systematically overpriced

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http://www.ropesgray.com/litigationalert/ ("The immediate consequences of the *Harris* opinion are difficult to predict.").

165. *Id.*

166. Norris, *supra* note 163.

167. *Jones v. Harris Assocs*., 129 S. Ct. 1579 (2009).

168. Supreme Court, November 2, 2009 Session, http://www.supremecourtus.gov/oral_arguments/argument_calendars/MonthlyArgumentCalNovember2009.html (last visited Aug. 27, 2009).

169. Freeman et al., *supra* note 17, at 126.

170. *Id.*

171. *Id.* at 86.

172. *Id.*

and set forth two proposals for changing the environment in which the fees are "set, disclosed, and evaluated."[173] First, they proposed requiring funds to report financial information on a standardized basis. They hypothesized that standardized reporting would allow investors to compare costs.[174] Second, they proposed requiring funds to disclose advisory fee arrangements with nonfund clients.[175] Most recently, building on their earlier work, they have proposed that the *Gartenberg* factors should be replaced with a new framework—the *McDonnell Douglas* test that the Supreme Court outlined when it analyzed a disparate treatment employment discrimination case based on circumstantial evidence.[176]

Other scholars criticized *Gartenberg* for its practical failure to provide the meaningful shareholder protection that Congress intended. Professor Langevoort has argued that *Gartenberg* parallels state law corporate waste statutes "even though the legislative history behind section 36(b) explicitly wanted something more than a waste test."[177] Others have argued that it is riddled with "ambiguity"[178] for seemingly allowing plaintiffs to establish a breach of fiduciary duty by a materially flawed process but then requiring "a substantive economic showing of fee excessiveness [as the] *sine qua non* of liability."[179] How lower courts resolve this ambiguity influences

173. Freeman & Brown, *supra* note 33, at 614.

174. *Id.* at 669.

175. *Id.*

176. Freeman et al., *supra* note 17, at 144–45 ("Under the *McDonnell Douglas* framework, once a prima facie case of disparate treatment is made, the defendant must produce evidence to rebut the presumption of discrimination. At this point it becomes incumbent on the defendant to articulate a legitimate non-discriminatory reason explaining why the disparity exists. In the fund fee context, the advisor would need to produce evidence showing that the captive fund was fairly treated—a task it could accomplish by identifying and quantifying the service differences between picking portfolio securities for third-party institutional clients versus the captive mutual fund. Once the defendant has presented evidence to explain the fee disparity, it remains for the plaintiff to show the pricing disparity evidences a breach of fiduciary duty. The plaintiff would do this by proving, by a preponderance of the evidence, that the differences in services the defendant identified do not adequately explain or justify the fee disparity. Here, the plaintiff's ultimate burden will be to show that the captive fund was charged substantially more than free market clients for like work." (footnote omitted)).

177. Langevoort, *supra* note 8, at 1024.

178. John M. Greabe et al., *Moving Beyond* Gartenberg*: A Process-Based and Comparative Approach to § 36(b) of the Investment Company Act of 1940*, 28 ANN. REV. BANKING & FIN. L. 133, 146 (2009). The authors represent the plaintiffs in *Jones v. Harris Associates*. Jones v. Harris Assocs., 527 F.3d 627, 629 (7th Cir. 2008).

179. Greabe et al., *supra* note 178, at 146.

liability.[180] Another scholar criticizes its "shrunken conception" of independence and proposes moving to a broader idea of director "interestedness" that correlates with "independence" in corporate law.[181] These critiques make convincing arguments that *Gartenberg* does not do enough to protect shareholders. But, following the analysis of *Harris Associates* in the next Section, Part IV demonstrates that *Gartenberg* remains useful because it may be modified to further Congress's goal of guarding against excessive fees.

B. Analysis of Chief Judge Easterbrook's Standard

Chief Judge Easterbrook substituted a new standard for proving the breach of a fiduciary duty in mutual fund excessive fee cases. His new standard scuttles the *Gartenberg* standard, which prohibited fees that were "so disproportionately large" that they bore "no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining."[182] Easterbrook's standard does not require arm's-length bargaining; it merely requires that "a fiduciary must make full disclosure and play no tricks," while acknowledging that compensation could be "so unusual" that a court would infer deceit.[183] This Section concludes that Easterbrook's standard is inappropriate because of its blind embrace of the market, which renders Section 36(b) null. Part IV proposes modifications to the *Gartenberg* standard that incorporate the market as championed in *Harris Associates*, but does so in a way that furthers Congress's intention of protecting investors.

1. *Easterbrook Is Engaged in Statutory Sunsetting*. A sunset law is a statute that "automatically terminates at the end of a fixed period unless it is formally renewed."[184] Typically, however, laws do not have sunset provisions and go on indefinitely. Like most laws, Section 36(b) does not have a time limit, but Chief Judge Easterbrook thought its time had passed. He refused to rely on the statements and

180. *Id.* at 149.

181. Johnson, *supra* note 17, at 528.

182. Gartenberg v. Merrill Lynch Asset Mgmt., 694 F.2d 923, 928 (2d Cir. 1982).

183. *See supra* notes 126–27 and accompanying text.

184. BLACK'S LAW DICTIONARY 1478 (8th ed. 2004). Thomas Jefferson was an early proponent of sunset laws, arguing that no legislation or constitution should last for more than nineteen years. In contemporary times, commentators have advocated sunset laws for regulatory statutes and agencies. GUIDO CALABRESI, A COMMON LAW FOR THE AGE OF STATUTES 59–60 (1982).

beliefs about the mutual fund industry at the time that "Congress deemed competition inadequate (and regulation essential)."[185] He emphasized that "[a] lot has happened in the last 38 years."[186] The examples in this Section illustrate that Easterbrook ignored the language of Section 36(b) in an effort to sunset the statute—that is, interpret it out of practical existence.

a. Easterbrook's Standard Satisfies His Two Basic Components of Securities Law but Ignores the Plain Language of the Statute. Traditionally, a fiduciary duty encompasses a duty of care and a duty of loyalty as well as an obligation to act in good faith.[187] Easterbrook's new standard falls far short of those standards and merely requires "no tricks" and "full disclosure." These two pillars parallel his "two basic components" of securities law, which he outlined in a 1984 academic article: "a prohibition against fraud, and requirements of disclosure."[188] The prohibition against fraud is exemplified by the no tricks requirement, while his emphasis on disclosure translates to full disclosure in *Harris Associates*.

Disclosure allows boards and shareholders to make informed decisions. An informed decision, however, may be a necessary, though not sufficient, condition for an investment advisor to meet its fiduciary duty. The statute requires more than full disclosure because Congress elected not to give conclusive weight to the board's decisions.[189] That is, even if disclosure were perfect and the board and shareholders approved the advisory fee contract, a court could still find that the investment advisor breached its fiduciary duty. Congress likely left courts this option because it realized that full disclosure does not protect investors in the mutual fund industry because the market is not efficient.[190] It is unlikely, therefore, that disclosure alone would fulfill the fiduciary duty Congress established in Section 36(b). Easterbrook's new standard allows full disclosure to insulate investment advisors when the statute does not, and thus his standard contravenes the statute.

185. Jones v. Harris Assocs., 527 F.3d 627, 633 (7th Cir. 2008).

186. *Id.*

187. Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006).

188. Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 669 (1984).

189. 15 U.S.C. § 80a-35(b)(2) (2006).

190. For a discussion of the inefficiency of the mutual fund market, see Part III.B.2.

Easterbrook's prohibition against fraud (no tricks) also ignores the language of the statute, which expressly states that "[i]t shall not be necessary to allege or prove that any defendant engaged in personal misconduct." Though the statute does not define personal misconduct, playing tricks likely would be an example. Easterbrook, however, would require plaintiffs to show that the investment advisor "pulled the wool over the eyes of the disinterested"[191] board members if the advisor made a full disclosure—a showing of misconduct that the statute's plain language does not require.

One prong of Easterbrook's standard—disclosure—does not protect advisors from excessive fee findings according to the plain language of the statute. The other prong—no tricks—is expressly not required by the statute. While Easterbrook's standard parallels his view of the purpose of the securities laws by prohibiting fraud and secrecy, the fiduciary duty established by the statute requires more.

b. Easterbrook Gives Boards More Power than the Statute Gives Them. Easterbrook powerfully summons trust law to define the fiduciary duty in Section 36(b). He states that, "when the settlor or the persons charged with the trust's administration make a decision, it is conclusive."[192] Analogized to the mutual fund industry, when the boards of directors charged with making decisions regarding advisory contracts make those decisions, they are conclusive.[193] As Part I noted, however, investment advisors appoint mutual fund board members. That leaves the investment advisor seemingly sitting on both sides of the contract negotiations. This situation resembles a conflict of interest that does not exist in typical trust law. To partially alleviate this conflict of interest, Congress uniquely protected shareholders by giving weight, but not conclusive weight, to board decisions.

The only time that the Easterbrook standard would not give conclusive weight to a board decision would be if the "compensation [was] so unusual that a court [would] infer that deceit must have occurred."[194] This interpretation blatantly disregards the statutory language, which states that approval by the board of directors or the shareholders "shall be given such consideration by the court as is deemed appropriate under all the circumstances."[195] Easterbrook

191. *Harris Assocs.*, 527 F.3d at 635.
192. *Id.* at 632.
193. 15 U.S.C. § 80a-15(c) (2006).
194. *Harris Assocs.*, 527 F.3d at 632.
195. 15 U.S.C. § 80a-35(b)(2).

reduced "all the circumstances" to situations in which courts can infer deceit. Simply stated, Easterbrook gave more weight to boards' decisions than did Congress.

In sum, Easterbrook reduced the value of the fiduciary duty to shareholders by ignoring the prescriptions of the statute that do not require a showing of personal misconduct and that give board decisions appropriate consideration under all circumstances but not conclusive weight. To offer any protection to shareholders in practice, the limited fiduciary duty that Easterbrook created would require an efficient market. But when Congress enacted Section 36(b) it found that an efficient market did not exist in the mutual fund industry. Many scholars continue to agree, though dissent exists.

2. *Easterbrook's Standard Fails to Protect Shareholders in an Inefficient Market*. Easterbrook applied his dominating principle of securities regulation—"anyone willing to disclose the right things can sell or buy whatever he wants at whatever price the market will sustain"[196]—to the mutual fund industry. This application produced the disclosure-based standard set forward in *Harris Associates*. An important assumption underlies this dominating principle—that the product, here investment management, is sold in an efficient market. If the market is not efficient—that is, if it is not price competitive—then the market is not actually establishing and sustaining the price, but taking the price established by a monopolist, cartel, or regulator. Disclosure does not make a market efficient, but it does make pricing in an efficient market accurate.

Harris Associates' disclosure-based standard relies on Professor Coates and Dean Hubbard's argument that the mutual fund industry is price competitive[197] and that the structure of captive boards and nearly irreplaceable investment advisors does not hinder that competitiveness.[198] But many scholars disagree with Professor Coates and Dean Hubbard's conclusion that the mutual fund industry is efficient. Two industry critics on different sides of the ideological spectrum, Peter Wallison from the American Enterprise Institute and Robert Litan from the Brookings Institute, do not believe that the

196. Easterbrook & Fischel, *supra* note 188, at 670.

197. Coates & Hubbard, *supra* note 12, at 154 ("[W]e find that enough investors are sensitive to advisory pricing that higher fees significantly reduce fund market shares.").

198. *Id.* at 153 ("The periodic attacks on the mutual fund industry start with a correct premise—that mutual fund boards rarely fire advisers—but reach a faulty conclusion—that the structure of mutual funds prevents competition.").

mutual fund industry is price competitive. According to Wallison and Litan, competitive markets conform to the "law of one price," meaning that prices converge at a common level.[199] In the mutual fund industry, however, prices do not conform to a common level. In fact, the authors note that the price dispersion in one large sector of the mutual fund industry is 300 percent.[200]

In addition to failing to conform to the law of one price, the mutual fund industry does not have other traditional markers present in efficient markets. Mutual funds shares are not traded in organized markets; therefore arbitrageurs cannot take advantage of mispricing.[201] Insider compensation is based, not on performance, but on assets under management. Directors are paid in cash and not shares of the fund. Institutional investors do not push down prices for retail investors. And finally, no external market for corporate control exists because shares are redeemable.[202] The lack of these markers led Professor Langevoort to warn against a "facile analogy"[203] between mutual funds and business corporations because the markers of an efficient market do not "operate[] with any power in the world of mutual funds."[204]

Without the strictures of an efficient, competitive market, Easterbrook's dominating principle of "anything, at any price, as long as there is appropriate disclosure" perpetuates inflated compensation for investment advisors. Although full disclosure does not ensure competitive pricing, regulation may. Congress regulated investment advisors' fees by adopting the fiduciary duty in Section 36(b). Congress intended that this duty protect shareholders. That protection should not be sacrificed by the Seventh Circuit's determination that an efficient market offers investors all the protection they merit.

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199. *See* WALLISON & LITAN, *supra* note 7, at 8 ("The [mutual fund] industry . . . does not appear to conform to the 'law of one price'—that is, the prices of the collective investment services that mutual funds provide are not converging toward a common level, although convergence would be expected in a competitive market.").

200. *Id.* at 9.

201. *E.g.*, Cox & Payne, *supra* note 17, at 911 ("[I]t is not conceivable that meaningful arbitrage can be introduced efficiently in the pricing of mutual fund shares . . . ."); Edwin J. Elton, Martin J. Gruber & Jeffrey A. Busse, *Are Investors Rational? Choices Among Index Funds*, 59 J. FIN. 261, 286 (2004) (observing that arbitrage opportunities do not exist in mutual funds).

202. Langevoort, *supra* note 8, at 1032.

203. *Id.* at 1031.

204. *Id.*

IV. DEVELOPING AN APPROPRIATE FIDUCIARY DUTY: PROPOSALS FOR CHANGE

As the mutual fund industry grows in size and importance to American household, retirement, and education savings, the fiduciary duty that Congress established in 1970 should be interpreted in a way that maximizes shareholder protection while utilizing market forces to do so. *Harris Associates*' assurance that the market gives mutual fund shareholders what they deserve does not erase the fiduciary duty Congress imposed.

It is imperative that gains are not unreasonably siphoned to the managers to the detriment of the shareholders.[205] Both shareholders and boards must vigilantly monitor the level and types of fees investment advisors demand because fees compound out of investors' bottom lines just as interest compounds into them. Ideally, mutual fund investors should select their funds based on low fees and boards should enforce a well-developed fiduciary duty. Although the courts cannot affect investor purchasing patterns, they can develop a meaningful fiduciary duty.

The law of fiduciary duty is situation-specific.[206] The fiduciary duty in Section 36(b) as interpreted under either *Gartenberg* or *Harris Associates* is far from the "punctilio of an honor"[207] that Justice Cardozo described while sitting on the New York state bench. Professor Deborah DeMott has attributed the elusiveness of fiduciary obligations to their nascence in courts of equity rather than law.[208] Rules like the business judgment rule,[209] which guides courts in most of their dealings with corporate boards, can define fiduciary duties, but their situation-specific nature makes fiduciary duties more akin to standards.

Though Section 36(b)'s fiduciary duty requires situation-specific analysis, the evolution and requirements of the duty can be explained through a framework introduced by Professor Edward B. Rock. He suggests that Delaware corporate law standards are articulated

205. John Bogle argues that this is already happening as managers charge excessive fees and focus on salesmanship over stewardship. BOGLE, *supra* note 11, at 167.

206. Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879, 879.

207. Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928).

208. DeMott, *supra* note 206, at 880.

209. *See* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (discussing the business judgment rule).

through narrative processes—that judges, like preachers, tell instructive stories that guide the actions of others.[210] This narration leads to a set of parables[211] that "fill out the normative job description . . . of critical players."[212] The fiduciary duty that Congress created in Section 36(b) can be analyzed like Delaware corporate law because the community of investment advisors and mutual fund board of director members is similar in size[213] and composition to the "surprisingly small . . . community"[214] of senior managers and directors of large public companies and their lawyers. Owing to this similarity, Professor Rock's observation regarding the development of corporate law through evolutionary narratives can guide the development of the fiduciary duty under Section 36(b).

Judicial opinions are like data points that shape the narratives that guide directors' understanding of their jobs. Boards of directors and courts have already begun incorporating the *Gartenberg* factors into the narrative of Section 36(b) fiduciary duties.[215] The addition of *Harris Associates* as a new data point confuses the narrative because *Harris Associates* changed the fiduciary duty standard from a fairness-based to a disclosure-based standard. This change leaves boards asking how they should navigate *Harris Associates* and *Gartenberg* simultaneously. Should boards continue to be concerned with the harbingers of arm's-length bargaining like *Gartenberg* mandates? Or has the board performed its duty by making a decision that is not "so unusual" that a court will infer deceit as *Harris Associates* allows? Does it depend on the circuit in which the board sits? Rock's principal observation—that courts develop law through a narrative process—shows the potential power of *Harris Associates*. As *Harris Associates* becomes part of the narrative, it will assume power by

210. Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1016 (1997).

211. *Id.*

212. *Id.*

213. Though over eight thousand mutual funds exist, fewer than seven hundred firms serve as fund sponsors. INV. CO. INST., *supra* note 2, at 13, 15.

214. Rock, *supra* note 210, at 1013.

215. *See e.g.*, Martin & Lybecker, *supra* note 108 ("Independent directors should continue to consider the *Gartenberg* factors . . . . The *Gartenberg* approach has shaped how mutual fund boards of directors have conducted so–called 15(c) renewals for almost thirty years . . . . [B]oards of directors can clearly document that they have served as independent watchdogs on the management of investment companies by continuing to review the nature and quality of the services provided to the investment company and its shareholders."); Krinsk v. Fund Asset Mgmt., 875 F.2d 404, 409–12 (2d Cir. 1989) (discussing each *Gartenberg* factor).

impacting mutual fund attorneys and boards of directors' deliberations and decisions regarding fees. But *Harris Associates* should not be given such power. Its disclosure-based standard runs counter to Congress's intent in establishing Section 36(b).

Gartenberg, too, though it plays a starring role in the existing narrative surrounding the fiduciary duty in excessive fee cases, has not proven that it can carry out Congress's intent. Recall that shareholders have never won under *Gartenberg*.[216] Some commentators have suggested creating a new standard for proving excessive fee cases.[217] But this proposal would create uncertainty by clearing away the narrative work that courts have built up to this point. Instead of building a new fiduciary duty from scratch, the Court should continue to use the *Gartenberg* factors with two important modifications. These modifications would strengthen the integrity of the fiduciary duty between investment advisors and shareholders, while requiring courts and boards to only slightly modify their analysis. Continuing to use a factor-based test like *Gartenberg* would allow the courts to discuss in detail case-specific facts, building a narrative that would help define the contours of Section 36(b)'s fiduciary duty and guide future boards when approving fees.[218]

First, as Judge Posner and the *Harris Associates* plaintiffs argued, *Gartenberg*'s fifth factor, comparative fee structures, must be broadened to include a comparison of the fees mutual fund clients and institutional clients pay. As this Section explains, advisors should be able to pass the additional variable costs of administering a retail fund over an institutional fund to retail clients,[219] but a management

216. *See* sources cited *supra* note 17.

217. Freeman et al., *supra* note 17, at 144–45 (proposing replacing the *Gartenberg* test with the *McDonnell Douglas* framework).

218. The *Gartenberg* factors do not have to end a board's fiduciary duty analysis. Professor Rock suggests that factors and cases can guide critical players like boards but do not create a safe harbor from vigilantly performing their duties. Confusion reigns when "a player interprets the cases as establishing a substantive safe harbor, rather than explicating a conduct norm." Rock, *supra* note 210, at 1063. Boards should work to protect shareholders even if that work takes them beyond *Gartenberg*.

219. The plaintiffs in *Harris Associates* "maintain[ed] that a fiduciary may charge its controlled clients no more than its independent clients." Jones v. Harris Assocs., 527 F.3d 627, 631 (7th Cir. 2008). This Note disagrees. A fund should be able to charge its controlled clients more than institutional clients if the difference in price arises from actual administrative cost differences. It may be objectionable, however, for a fund to *profit* from its controlled clients more than from its independent clients when that extra profit results from a lack of arm's-length bargaining.

fee in excess of the additional administrative costs should strongly indicate investment advisors have breached their fiduciary duties.[220] Next, the second *Gartenberg* factor, the profitability of the fund to the advisor-manager, should be eliminated because it removes market-based incentives for investment advisors to lower fees.

A. Broaden the Comparative Fee Structure Factor

The statute's legislative history, although "tortuous,"[221] can help determine the broad principles behind the fiduciary duty that Congress enacted through Section 36(b). Though the SEC and the mutual fund industry, the two primary actors engaged in the legislative debates, never agreed on what the fiduciary duty required,[222] a sensible starting point is that Congress sought fairness, not reasonableness,[223] in fee contracts.[224] Congress intended the fiduciary duty to furnish a "mechanism by which the fairness of management contracts could be tested in court."[225]

Arm's-length bargaining is a proxy for fairness because it precludes self-dealing. But Congress recognized that arm's-length bargaining does not occur in the mutual fund industry over fees. A Senate report stated that "[t]he forces of arm's-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy."[226] A House report echoes that sentiment: "[N]egotiations between the unaffiliated directors and fund advisers over advisory fees would lack an essential element of arm's-length bargaining—the freedom to terminate the negotiations

220. Professor Freeman focuses on courts', not boards', recognition of comparables' power, and maintains that when investment advisors treat a third-party more favorably than their retail clients, that difference should be prima facie evidence of a breach of fiduciary duty. Freeman et al., *supra* note 17, at 144. This Note's "strongly indicative" standard engages both boards and courts to broaden the narrative development of the fiduciary standard. It also allows for the investment advisor to offer a legitimate basis for a larger profit spread.

221. Gartenberg v. Merrill Lynch Asset Mgmt., 694 F.2d 923, 928 (2d Cir. 1982).

222. *See* Rogers & Benedict, *supra* note 41, at 1084 ("[T]he Commission and the industry never did concur on what the term 'fiduciary duty' meant in this context.").

223. *See id.* at 1082–89 (describing Congress's rejection of the reasonableness standard and the legislative compromise that followed).

224. The industry would likely agree with the fairness standard. *See* Coates & Hubbard, *supra* note 12, at 204 ("Absent a clear statute, courts fall back on the common law, and absent the presumption of the business judgment rule, that standard would ordinarily be a 'fairness' standard.").

225. S. Rep. No. 91-184, at 5 (1969).

226. *Id.*

and to bargain with other parties for the same services."[227] Because Congress recognized the industry's lack of arm's-length negotiations but expected fairness anyway, it is reasonable for courts to compare fees negotiated in arm's-length contracts to those in mutual fund contracts. This comparison would incorporate bargained-for, market-set fees into the fiduciary duty standard without relying on the inefficient mutual fund market as *Harris Associates* demands.

The most natural comparison is to the fees that noncaptive, institutional investors, like pension funds, pay.[228] The investment advisor performs a substantially similar job—investing pools of money—for both clients, but the money has different owners (either retail investors or institutional investors). The difference in the fee-setting process between mutual funds and their investment advisor and pension funds and their investment advisor is that pension fund contracts are negotiated at arm's length, whereas boards appointed by the investment advisor approve the contract for mutual funds.[229]

The mutual fund fee negotiation more closely resembles self-dealing than arm's-length bargaining because the investment advisor sits on both sides of the deal: the investment advisor is the seller and the mutual fund's board, appointed by the investment advisor, is the buyer. This has a significant impact on the level of fees charged to the investor. A 2001 study found that mutual funds paid double the advisory fee that pension funds paid to investment advisors, fifty-six basis points rather than twenty-eight basis points, even though mutual funds are on average three times larger than pension funds.[230] That translates to managers being paid an average of $1.2 million to manage an institutional fund's money and $7.38 million (over six times greater) to manage a mutual fund's money.[231] This difference hardly conforms to Congress's goal of fairness.

Fairness does not necessarily mean that retail investors and institutional investors should be charged the same fees. Actual

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227. H.R. Rep. No. 89-2337, at 131 (1966), *available at* http://sechistorical.org/collection/papers/1960/1966_InvestCoGrowth/CH3D.PDF.

228. The Eighth Circuit ruled on April 8, 2009, that the district court erred when it rejected a comparison between fees paid by institutional and mutual fund clients. Gallus v. Ameriprise Fin., Inc., 2009 U.S. App. LEXIS 7382 (8th Cir. 2009).

229. Jones v. Harris Assocs., 537 F.3d 728, 731–32 (7th Cir. 2008) (Posner, J., dissenting from denial of rehearing en banc) (quoting Freeman & Brown, *supra* note 33, at 634).

230. Freeman & Brown, *supra* note 33, at 631. One would expect the larger funds to pay smaller fees, as a percentage of assets under management, due to economies of scale.

231. *Id.*

administrative cost differences should be passed through to mutual fund shareholders; wider profit margins accruing to an investment advisor from its mutual funds compared to its institutional funds, however, should trigger a rebuttable presumption of a breach of fiduciary duty.

No well-known cost differences between managing money owned by retail investors and managing that owned by institutional investors exist,[232] but retail investors may produce additional administrative costs.[233] If retail investors actually create additional administrative costs, investment advisors should be able to pass those costs on to retail investors. These pass-through costs are costs that the fund would not incur *but for* the retail clients. The variable costs and fixed costs investment advisors incur would be distributed among the investors in the fund family. Each investor would be responsible for its pro-rata share of fixed costs, and retail investors would bear any additional variable costs they create. If, after allocating the appropriate pass-through costs to retail investors, any difference remains between the fee paid by the retail funds and the fee paid by the institutional client, this difference is additional profit for the investment advisor.

Legitimate reasons may exist for a larger profit spread,[234] but the burden should be on advisors to prove that their services are worth more to one type of client than another. Boards and courts should regard discrepancies between institutional client fees and mutual fund fees in excess of the pass-through costs as indicative of a breach of fiduciary duty. Broadening the comparison to fees negotiated by institutional clients while permitting investment advisors to pass additional administrative costs to retail investors allows both boards and courts to protect shareholders from excessive fees, as Congress intended.

In practice, for boards to compare their mutual fund's fee to the investment advisor's institutional clients' fees, the advisor would have

232. *Id.* at 634.

233. Chief Judge Easterbrook suggested reasons why retail investors may be charged more. Jones v. Harris Assocs., 527 F.3d 627, 634–35 (7th Cir. 2008). Judge Posner noted that "[t]he panel opinion throws out some suggestions on why this difference may be justified, but the suggestions are offered purely as speculation, rather than anything having an evidentiary or empirical basis." *Harris Assocs.*, 537 F.3d at 731 (Posner, J., dissenting from denial of rehearing en banc).

234. For example, it may require more skill to manage the liquidity needs of a retail fund, thus warranting higher profit.

to disclose clearly delineated fees, and report fees and expenses independently from one another.[235] Both researchers who criticize and who support the industry have identified commingling fees and expenses as a problem.[236] Because a discrepancy between retail and institutional funds should strongly indicate a breach, boards would be forced to demand that funds justify additional cost.[237] If boards did not, they would be shirking their responsibility to shareholders.[238] Even if boards were satisfied that additional costs were warranted, under this standard, courts could still find that the investment advisor breached its duty to shareholders. Section 36(b) does not give the board's decision conclusive weight, but only such consideration as is appropriate in all circumstances.[239] This provision of the statute ensures that a completely independent body can review the transaction for fairness if the shareholders demand review by suing.

Pass-through costs are likely to foster creative accounting as funds designate costs as either variable or fixed. This problem raises the question of who will police the pass-through costs. The SEC should require that the pass-through cost be a reportable number, subject to audit. The board would therefore not be responsible for determining which costs should be considered variable or fixed. But the board would be responsible for approving the level of variable costs the investment advisor was passing through to the shareholders as a part of the yearly 15(c) contract review.[240]

Broadening *Gartenberg*'s comparative fee structure factor to include a comparison between the fees paid by mutual funds and institutional investors would introduce arm's-length bargaining, a proxy for fairness, into mutual fund excessive-fee cases. By allowing

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235. *See* Freeman & Brown, *supra* note 33, at 669 (proposing a uniform, clearly delineated system of expense reporting).

236. *See* Coates & Hubbard, *supra* note 12, at 187–88 ("Data are not readily available to accurately isolate the pure costs of portfolio management . . . ."); Freeman et al., *supra* note 17, at 109 ("[I]t is undoubtedly correct that a minor amount of commingling of expense items sometimes exists and—quite regrettably—frustrates perfect apples-to-apples comparisons on a universal basis.").

237. This will require that investment advisors disclose these fees to the boards as part of the yearly 15(c) contract approval process.

238. Boards do not have a fiduciary duty to shareholders under Section 36(b), but they are accountable to shareholders through state law. *See* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) ("Under Delaware law . . . the business and affairs of a Delaware corporation are managed by or under its board of directors. . . . [D]irectors are charged with an unyielding fiduciary duty to the corporation and its shareholders.").

239. *See supra* note 90 and accompanying text.

240. 15 U.S.C. § 80a-15(c) (2006).

mutual fund investors the benefit of profit spreads negotiated at arm's length and simultaneously preserving compensation for any real differences that exist in administrative costs, the pricing structure this Note suggests fulfills Congress's intent that mutual fund investors be charged fair fees. This revised interpretation of *Gartenberg*'s fifth factor would become part of the narrative that boards and investment advisors consider when performing their duties owed to shareholders. It would become the norm for investment advisors to provide boards with information regarding the level of fees charged to institutional clients and for boards to compare that information to the level of fees charged to their mutual fund clients. Both boards and courts would routinely review any identified discrepancies.

B. Eliminate the Profitability Factor

Investment advisors are money managers, not volunteers. They are, and should be, working for a profit. Section 36(b) does not require that the investment advisor charge the lowest possible fee, only a fair fee. If an investment advisor can make a relatively high profit without inflating fees, the advisor should not be punished with a strike against it in a *Gartenberg* proceeding. Consider an investment advisor over two years. In the first year, the advisor charged a management fee of seventy-five basis points, of which fifty basis points were profit and twenty-five basis points covered costs of the advisor. In the second year, the advisor charged the same fee but made sixty basis points of profit because the advisor drove down costs to fifteen basis points. This change did not affect investors because they paid the same level of fees regardless of the manager's profit margin. Investment advisors would be incentivized to drive down costs because cost savings would accrue to their profit spread, whereas investors would continue to pay the same amount. This approach encourages efficiency in the industry without a negative effect on the investor's bottom line.

Advisors could conceivably pass on the cost savings in the form of lower fees in two ways. First, an investment advisor could determine that, to attract new customers, it will lower its fee.[241] The investment advisor would still be making a comfortable profit while passing savings on to investors. Next, institutional clients could begin to demand that they also benefit from these savings, so mutual funds

241. This assumes investment advisors believe that investors will become or are already sensitive to fees when selecting a fund.

would benefit because of the broadened comparative fee analysis Part IV.A.1 suggests.

Retail investors and institutional investors are unlikely to realize these savings if *Gartenberg* continues to require courts and boards to consider profitability. The profitability factor removes incentives from advisors to lower costs; if the cost savings increase advisors' profits, the board could take that profit away in the next fee negotiation or courts could mark a strike against them in a traditional *Gartenberg* analysis. Investment advisors do not have a reward to correspond to the risk they take by lowering fees. The mutual fund industry should reward, not punish, efficiency when possible. Eliminating the profitability factor would take a step in that direction.

CONCLUSION

Two thousand eight was a trying year for most investors: home values fell and portfolios plummeted.[242] In the months following Chief Judge Easterbrook's decision in *Jones v. Harris Associates*, the credit crisis cost investors trillions[243] and frauds like the Madoff Ponzi scheme[244] contributed to a decline in confidence in the markets. In hindsight, it was a tough year to argue for less shareholder protection. But that is just what the *Harris Associates* majority did. The Seventh Circuit broke with a thirty-year-old precedent, *Gartenberg*, under which a plaintiff had never prevailed in court, to eviscerate any remaining protection shareholders had under the fiduciary duty in Section 36(b).

To meaningfully assert the protection Congress intended for shareholders, this Note proposes modifying the fifth *Gartenberg* factor, comparative fee structures, to include a comparison between retail fund fees and institutional fees. This change would broaden the fiduciary analysis under *Gartenberg* while maintaining the narrative structure that courts and boards have already developed. Additionally, eliminating the profitability factor would incentivize

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242. *Year-End Review of Markets & Finance 2008 – SOS: 'Save Our Stocks' – A Look Back at a Year of Bailouts, Underwater Investors and Sunken Hopes*, WALL ST. J., Jan. 2, 2009, at R9.

243. Timothy R. Homan, *IMF Says Losses from Crisis May Hit $4.1 Trillion*, BLOOMBERG, Apr. 21, 2009, http://www.bloomberg.com/apps/news?pid=20601087&sid=azkSmZrrIHKQ.

244. *See generally Con of the Century*, ECONOMIST, Dec. 20, 2008, at 119 (describing the Madoff scandal and estimating a $50 billion cost to investors); Evan Perez and Steve Stecklow, *Stanford Is Indicted in Fraud, Surrenders*, WALL ST. J., June 19, 2009, at C1 (reporting Allen Stanford's indictment for fraud).

investment advisors to reduce fees by allowing them to reap the rewards of those fee reductions. The Court should resist Chief Judge Easterbrook's new standard because, although a fiduciary duty may no longer be the "punctilio of an honor"[245] it once was, it is more than a prohibition against fraud and secrecy.

245. Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928).